

JOINT STATEMENT

FOR

THE WAYS AND MEANS COMMITTEE
ENERGY WORKING GROUP

OF

THE AMERICAN INSTITUTE OF ARCHITECTS
THE AMERICAN COUNCIL OF ENGINEERING COMPANIES
ASSOCIATED BUILDERS AND CONTRACTORS
ASHRAE

APRIL 15, 2013

On behalf of the design and construction industry, we commend the Ways and Means Committee for its work on the critical issue of tax reform, and we appreciate the opportunity to submit this statement.

Our statement focuses on the Energy Efficient Commercial Building Tax Deduction, which is contained in section 179D of the Internal Revenue Code (179D deduction). The 179D deduction, which is scheduled to expire at the end of 2013, has had a significant impact on energy efficiency investment, domestic manufacturing, and design and construction industry jobs.

Our organizations represent millions of design and construction professionals nationwide and around the world. As leaders in the design and construction industry, we support incentivizing the business community to provide energy efficiency innovations, particularly through provisions like the 179D deduction, which has proven successful.

The 179D deduction has leveraged billions of dollars in private capital, resulted in the energy-efficient construction and renovation of thousands of buildings, and created and preserved hundreds of thousands of jobs in the process. It is one of the best examples of the tremendous impact tax incentives can have on financing energy-efficient property and its success demonstrates the strong need to continue an energy efficiency provision in the tax code in some form.

In recognition of the benefits of the 179D deduction, there have been reform proposals offered in previous Congresses aimed at making it more compatible with retrofits and tie it to performance. We look forward to continued collaboration on these efforts.

Most importantly, the design and construction industry supports improvements to the 179D deduction that further foster energy-efficient commercial development and are consistent with the principles of tax reform, making it simpler and more effective. In this regard, as tax reform progresses, we strongly urge Congress to make permanent and enhance the 179D deduction by: (1) ensuring the ability of pass-through entities to capture the full value of an allocated deduction in the case of a public owner of a building; (2) increasing the value of the 179D deduction; and (3) allowing non-profit owners of buildings, similar to public owners of buildings, to allocate the deduction.

Background on Section 179D, the Energy Efficient Commercial Building Deduction

The Energy Efficient Commercial Building Deduction was created by the Energy Policy Act of 2005,¹ in recognition of the fact that a substantial portion of U.S. energy consumption is attributable to commercial buildings and to provide a tax incentive to help offset the costs associated with enhancing their energy efficiency. Section 179D of the Internal Revenue Code provides a deduction for certain energy-efficient commercial building property expenditures.

Eligible expenditures are for property which is: (1) installed on or in any building that is within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air

¹ The Energy Policy Act of 2005, Pub. L. No. 109-58.

Conditioning Engineers and the Illuminating Engineering Society of North America (“ASHRAE/IESNA”); (2) installed as part of the (i) interior lighting systems, (ii) heating, cooling, ventilation, and hot water systems, or (iii) building envelope; and (3) certified as being installed as part of a plan designed to reduce total annual energy and power costs by 50 percent or more. Critically, the deduction is effective only for property placed in service prior to January 1, 2014.

The maximum deduction is \$1.80 per square foot. In the case that a building does not meet the 50 percent energy savings requirement, a partial deduction of \$0.60 per square foot is allowed for each separate building system that comprises energy-efficient property and that is certified as meeting required savings targets. To encourage the public sector to utilize these same energy efficient enhancements, the 179D deduction also provides a federal, state, or local government owner of a commercial building an election to allocate the tax deduction to the primary person responsible for designing the energy efficient enhancements installed in the building. This is an important feature of the law. By assigning the 179D deduction to the primary person responsible for designing the energy efficient enhancements, it creates a targeted incentive that encourages design and construction teams to put extra effort into identifying and implementing energy saving enhancements in public buildings.

In the short-term, the 179D deduction enables building owners to offset a small portion of the often costly expenses associated with energy-efficiency enhancements. In the longer-term, building owners who take advantage of the 179D deduction realize significantly lower energy costs, the benefits of leading-edge design and construction that enhances the building’s long-term market value, and the benefits of a cleaner environment. Building owners utilize the deduction for both new construction projects and retrofits of existing buildings.

In the case of a public entity, the allocation of the 179D deduction, in the short-term, results in savings by allowing the public entity to negotiate a better deal and, in the long-term, allows the public entity to realize ongoing energy savings. The average 179D project (typically \$0.60/ sq. ft. for lighting upgrades) saves a public entity an average of 20 percent on their energy expenses. Even in cases where there are minimal upgrades that qualify for 179D, public entities have saved relatively large amounts.²

For example, a middle school initiated a project to retrofit its lighting system. An architect worked with the school to find a 12-percent energy saving on a single lighting system. The project qualified for the 179D partial lighting deduction. The school saved \$15,000 on its energy bill in the first year alone. Over ten years, that totals to over \$150,000 for a single school. School districts utilizing the 179D deduction to finance energy-efficient enhancements for five, ten, or 20 schools can save millions of dollars over ten years.³

This example illustrates the impact of just 12 percent energy savings in a single school. There are hundreds of other examples of the deduction providing even greater benefits to school districts, army bases, civic structures, and other publicly-owned buildings across the nation.

² Julio Gonzalez, CEO, Engineered Tax Services

³ Id.

Proposals to Improve the 179D Deduction

The design and construction industry supports common-sense proposals that make the 179D deduction simpler, more effective, and easier to use.

Allocating the Section 179D Deduction to a Pass-Through Entity

As discussed previously, the 179D deduction provides a federal, state, or local government owner of a commercial building an election to allocate the tax deduction to the primary person responsible for designing the energy efficient enhancements. In December 2010, the IRS released a memo that effectively prevents firms organized as partnerships or S corporations from fully realizing the benefit of a 179D allocated deduction.⁴

This is a critical problem, significantly undermining the intended effects of the 179D deduction. For example, the IRS reports that in 2007, nearly a third of architecture firms were organized as partnerships and S corporations and almost 80 percent of architectural firms have fewer than 10 employees.⁵ The vast majority of construction contractors are also organized as pass through entities. It is often these small and mid-size firms that typically work on state and local government projects such as schools and municipal buildings.

By way of background, an allocated 179D deduction is a tax deduction that does not reflect an economic cost to the recipient taxpayer, because, similar to a tax credit, the deduction provides an incentive. The technical tax rules nonetheless treat an allocated deduction as reflecting an economic cost to the taxpayer and accordingly reduce partnership and S corporation taxable income *and* the partners'/shareholders' basis in the partnership/S corporation (*i.e.*, "outside basis") by the amount of the allocated deduction. The reduced outside basis may force partners and S corporation shareholders to recognize taxable gain on the distribution of economic earnings that were excluded from tax by the allocated 179D deduction at the partnership and S corporation level. The IRS memo states that, in the absence of explicit statutory authority allowing for basis adjustments to preserve the benefit of the deduction at the partner or shareholder level, the technical tax rules govern. The result will be that, in the case of many partnerships and S corporations, the benefit of the 179D deduction will be lost or significantly diminished. This will harm not only these firms, but, more importantly, the school districts and other public entities who own the buildings.

In order for partnerships and S corporations to obtain the intended benefits, it is necessary for partners and S corporation shareholders to obtain a basis in their partnerships and S corporations that is not reduced by an allocated 179D deduction. This issue could be addressed by a simple statutory modification to expressly require Treasury to issue regulations that properly determine partnership or S corporation outside basis in the case where the 179D deduction is allocated. Such a clarification would provide certainty and address a widespread concern among many small businesses that design energy efficient buildings.

⁴ I.R.S. Chief Couns. Mem. AM2010-007 (Dec. 23, 2010).

⁵ I.R.S. Audit Technique Guide. (August 2011). http://www.irs.gov/pub/irs-utl/architects_atg.pdf

Enhancing the Section 179D Deduction

The maximum 179D deduction of \$1.80 per square foot has not been increased since the deduction was put in place in 2005 and, as a result, has not kept pace with inflation. Consequently, the impact of the 179D deduction has become blunted over time. Moreover, as the economy and financial markets continue their fragile recovery, the amount of capital available for building design, construction, and renovation continues to be limited. A recent AIA survey of architecture firms shows that nearly two-thirds report that a lack of financing has slowed or stopped construction projects that would create jobs.⁶ Owners are also less likely to invest the upfront capital costs associated with energy efficient systems, which often are somewhat more expensive to design, build, and install than their less efficient counterparts.

In 2010, a coalition of more than 80 organizations and companies called on Congress to increase the 179D deduction from the current maximum allowable amount of \$1.80 per square foot to \$3.00 per square foot.⁷ In the case of individual subsystems, the maximum allowable deduction should be increased from \$0.60 per square foot to \$1.00 per square foot. Bipartisan legislation was introduced in the Senate in the 112th Congress to enhance the deduction in this way (S. 3591).

Enhancing the 179D deduction would provide an important source of additional capital to stimulate building design, construction, and renovation, driving the creation of well-paying jobs. Studies have shown that every \$1 million invested in design and construction yields 28.5 full-time jobs.⁸ An enhanced 179D deduction would further incentivize energy efficiency, improve the nation's commercial building stock, and increase energy independence.

Allocating the Section 179D Deduction in the Case of a Non-Profit Owner of a Building

The 179D deduction allocation provision, which allows a federal, state, or local government owner of a building to allocate the deduction to the designer, has been used to great effect to encourage their public sector clients to meet the energy targets of the deduction and then have the client assign them the tax deduction. The result has been more energy-efficient public buildings and lower energy costs for the building owners.

In many cases, non-profit entities, such as hospitals, universities, private schools, charities, and foundations, conduct functions similar to state and local governments. Currently, non-profit entities own thousands of properties across the country. Although retrofits to these properties could result in significant energy savings, the non-profit entities do not pay taxes and, consequently, cannot benefit from the 179D deduction.

The 179D allocation provision should be expanded to provide non-profit owners of buildings, similarly to public owners of buildings, with the ability to elect to allocate the deduction to the primary designer of the building. Such a provision would assist non-profits in financing energy efficiency upgrades and would reduce their energy costs in the longer-term.

⁶ AIA Firm Survey 2010

⁷ http://www.efficientbuildings.org/about_the_provision.html.

⁸ Center for Regional Analysis Study. George Mason University, (2007).

Conclusion

The design and construction industry appreciates the opportunity to submit this statement to the Ways and Means Committee. As Congress considers tax reform, it is important to recognize the impact the 179D deduction has had in leveraging private capital and increasing energy-efficient construction and renovation. The 179D deduction is a successful provision that only needs minor tweaking. Making permanent and making modest improvements to the 179D deduction would increase the effectiveness and efficiency of this important tax policy. Our organizations and our members are ready to serve as a resource to and look forward to working with Congress and the Committee on these and other issues.